Effective Date: October 7, 1996

COORDINATED ISSUE
SHIPPING INDUSTRY
I.R.C. SECTION 167 SALVAGE VALUE

Issue:

Whether ships, barges or other vessels placed in service prior to the enactment of the accelerated cost recovery system (ACRS) require an estimation of salvage value for purposes of determining depreciation under I.R.C. § 167.[1]

Facts:

Ships have been recognized throughout history as long lived, expensive, capital intensive assets. They are recognized as essential to national security and trade in the United States and many other countries.

In a study of the U.S. dry cargo fleet, I.R.S. engineers found it common for WWII-built ships to be sailing at 40 years of age, especially converted vessels on "Jones Act" trades.[2] On average, seagoing U.S. flag vessels of all types should last 30-35 years, with periodic overhauls. Great Lakes ships usually last far longer than that. Because of the long lives of ships, depreciation under pre-ERTA law is not uncommon. A compliance problem has arisen with respect to depreciation of these ships placed in service prior to January 1, 1981.

Background:

Prior to ERTA, depreciation was based on the concept that the cost of an asset should be allocated over the period it is used to produce income. In general, property is depreciable if it is (1) used in a trade or business or for the production of income, and (2) subject to wear and tear, decay or decline from natural causes, exhaustion, or

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[1] Unless otherwise noted, all Code and regulations references contained herein are to the 1954 Code prior to its amendment by the Economic Recovery Tax Act of 1981 (ERTA).
P.L. No. 97-34, 1981-2 C.B. 256.

[2] The Jones Act was enacted to prevent a foreign person from transporting cargo from one U.S. port to another U.S. port on a foreign flag vessel. 46 U.S.C. § 861 et. seq.

obsolescence. In general, depreciation is limited to the cost or other basis of the property, less a reasonable estimate for salvage value. S. Rept. No. 144, 97th Cong., 1st Sess. 39, 1981-2 C.B. 412, 421. To compute depreciation, absent an accelerated method, salvage value is subtracted from the cost basis of property, and then that balance is recovered ratably over the property's estimated useful life. Treas. Reg. § 1.167(a)-1.

Law and Analysis:

I.R.C. § 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--(1) of property used in a trade or business, or (2) of property held for the production of income. The Supreme Court in Fribourg Navigation Co., Inc. v. Commissioner, 383 U.S. 272, 276 (1966), citing United States v. Ludey, 274 U.S. 295, 300-01 (1927), described the provision for depreciation as follows:

> The depreciation charge permitted as a deduction from the gross income in determining the taxable income of a business for any year represents the reduction, during the year, of the capital assets through wear and tear of the plant used. The amount of the allowance for depreciation is the sum which should be set aside for the taxable year, in order that, at the end of the useful life of the plant in the business, the aggregate of the sums set aside will (with salvage value) suffice to provide an amount equal to the original cost.

Under Treas. Reg. §§ 1.167(a)-1 and 1.167(b), tangible depreciable property placed in service before 1981 is depreciated by (1) determining the basis of the property, its estimated useful life, and estimated salvage value, and (2) applying a depreciation method that results in a reasonable allowance for depreciation.

Determination of Useful Life:

The estimated useful life is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. Treas. Reg. § 1.167(a)-1(b). The estimated useful life is to be determined by reference to the taxpayer's own experience with similar property taking into account present conditions and probable future developments. Treas. Reg. § 1.167(a)-1(b). The regulations further provide factors to be considered in estimating the useful life of an item of property: (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements.

Generally, useful life is determined based on the facts known at the time property is placed in service. However, estimated useful life may be redetermined but only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. Treas. Reg. § 1.167(a)-1(b).

Ordinarily, the obsolescence of an asset does not give rise to a redetermination of the asset's useful life. Rather, normal obsolescence is a consideration in determining an asset's useful life. Treas. Reg. § 1.167(a)-9. Obsolescence is attributable to many causes, including technological improvements, foreseeable economic changes, and legislative or regulatory actions. Normal obsolescence relates to the gradual improvements and progress in the arts and sciences leading to inadequacy brought about by developments in the industry, products, methods or sources of supply and other like changes. Abnormal obsolescence refers to radical or sudden technological, economic or legal changes that render an asset economically useless regardless of its physical condition. See Zimmerman v. Commissioner, 67 T.C. 94 (1976) (useful life of motel clearly shortened due to changes in traffic patterns). Where the taxpayer can show that obsolescence greater than had been assumed has shortened the estimated useful life, a shorter useful life and additional depreciation will be permitted. Treas. Reg. § 1.167(a)-9.

Intensive operations may affect useful life. Useful life may be shortened and depreciation accelerated by reason of the intensive use of equipment or property used in intensive overtime operations or under conditions or for purposes for which it was not designed or contemplated. In Copifyer Lithograph Corp. v. Commissioner, 12 T.C. 728 (1949), the taxpayer attempted to demonstrate that increased repairs of equipment used by inexperienced personnel merited accelerated depreciation. However, the court, at p. 734, pointed out that the increased repair expenses may demonstrate that the business deductions for such repair expenses adequately offset the increased wear and tear to the equipment.

Under Treas. Reg. § 1.167(a)-7(a), depreciable property may be grouped together to form an account. Assets may be grouped in an account in a variety of ways: (1) a "group account" consists of assets similar in kind with approximately the same useful life, (2) a "classified account" consists of assets segregated according to use without regard to useful life, e.g., machinery and equipment, and (3) a "composite account" consists of assets regardless of their character or useful life, e.g., all the assets used in a business. Treas. Reg. § 1.167(a)-7(b) - 7(d) provide the rules concerning the methodology of accounting for group accounts.

Evolution of the Class Life Asset Depreciation Range System (ADR):

In 1942, the Service issued Bulletin F, [1942] 1 Fed. Tax Rep. (CCH) ¶ 219.27, to provide guidelines of estimated useful lives and depreciation rates for various kinds of property classified according to types of business and industry. The lives and rates set forth in the Bulletin were based on average experience and were intended to assist taxpayers lacking their own historical experience to justify the selection of their estimated useful lives.

This guideline was replaced by Rev. Proc. 62-21, 1962-2 C.B. 418. Rev. Proc. 62-21 set forth various guidelines for determining the useful lives of depreciable assets within broad industry classes. The revenue procedure was designed to provide taxpayers with a greater degree of certainty in determining the amount of their depreciation deductions and to provide greater uniformity in the audit of these deductions by the Service. The revenue procedure provided that it was Service policy not to disturb depreciation deductions and that adjustments in depreciation were not to be proposed unless there was a clear basis for change.

The revenue procedure established an objective test, the "reserve ratio test," for determining whether the life selected by the taxpayer for each class of assets properly represented the average period of usefulness of the taxpayer's assets in his business. It measured the consistency between the class life used by the taxpayer with respect to a guideline class and the taxpayer's retirement and replacement practices for the depreciable assets in that class. In the event that a taxpayer could not satisfy the reserve ratio test, the taxpayer was required to demonstrate on the basis of his own facts and circumstances that his retirement and replacement practices were consistent with the class life used. See also Rev. Proc. 65-13, 1965-1 C.B. 759, which supplemented Rev. Proc. 62-21 by adding some new and transitional rules with respect to the reserve ratio test.[3] Rev. Proc. 62-21 was ultimately revoked for all years after 1970, except as expressly incorporated into Treas. Reg. § 1.167(a)-11(b)(5)(vi) and except as Treas. Reg. § 1.167(a)-12(f) permitted an election to apply the provisions of Rev. Proc. 62-21 for taxable years ending before 1971. Treas. Reg. § 1.167(a)-12(a)(2).

The Service issued new regulations in June of 1971 establishing the elective asset depreciation range (ADR) and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after

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[3] The application of the reserve ratio test was initially suspended for three years. In 1965, the reserve ratio test was substantially modified and new transitional rules were added which had the effect of further delaying the application of the test until about 1971. H.R. Rep. No. 533, 92d Cong., 1st Sess. 31 (1971), 1972-1 C.B. 498, 514.

1970.[4] Treas. Reg. § 1.167(a)-11(a)(1) provides that the system is designed to minimize disputes between taxpayers and the Service as to the useful life of property, and as to salvage value, repairs, and other matters. The regulations further provide that depreciation based on class lives and asset depreciation ranges is elective annually. The regulations instruct that the election be made with the taxpayer's return and that the taxpayer must establish vintage accounts for all eligible property included in the election, must determine the allowance for depreciation of such property in the taxable year of the election, and in subsequent taxable years, on the basis of the asset depreciation selected, and must apply the first-year convention specified in the election to determine the allowance for depreciation of such property.

Treas. Reg. § 1.167(a)-11(b)(3) defines vintage account to mean a closed-end depreciation account containing eligible property to which the taxpayer elects to apply ADR, first placed in service by the taxpayer during the taxable year of the election. The "vintage" of an account refers to the taxable year during which the eligible property in the account is first placed in service by the taxpayer. The regulations further provide that such an account will consist of an asset or group of assets within an established single asset guideline class. Treas. Reg. § 1.167(a)-11(b)(4) provides that asset guideline classes and periods will from time to time be published in the Internal Revenue Bulletin.

The ADR system was accepted by Congress when Congress enacted I.R.C. § 167(m), section 109 of the Revenue Act of 1971, P.L. No. 92-178, 1972-1 C.B. 443, 450. See also H.R. Rep. No. 533, 92d Cong., 1st Sess. 31 (1971), 1972-1 C.B. 498, 514. Under section 167(m), Treasury was directed to prescribe elective class lives which would reasonably reflect the anticipated useful life of various classes of property that would satisfy the reasonable allowance requirement for depreciation when depreciation was based upon the prescribed class lives. In addition, Treasury was given the authority to allow a variance from any class life by not more than 20 percent of such life.

Determination of Salvage Value:

Treas. Reg. § 1.167(a)-1(c) defines salvage value to mean the estimated amount (determined at the time of acquisition) the taxpayer expects to realize on the sale or other disposition of an asset at end of its useful life in taxpayer's business (or the production of taxpayer's income) and taxpayer's retirement of the asset. The regulations further provide that salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to

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[4] The ADR is no longer available for assets first placed in service after 1980 (except to the extent that it remains in effect for property excluded from the ACRS by reason of the anti-churning rules).

depreciation or by a reduction in the rate of depreciation but in no event may an asset or an account be depreciated below a reasonable salvage value. Whether a salvage value is reasonable depends, in part, on the taxpayer's policy with respect to disposing of assets. The regulations provide that if the taxpayer's practice is to dispose of assets when they are in relatively good condition, the salvage value will be a large percentage of the original basis whereas if the taxpayer uses the assets until they are exhausted, salvage value will be its junk or scrap value. Salvage value is estimated at the time of acquisition but may be redetermined should the facts and circumstances warrant the redetermination of the useful life of an asset.

I.R.C. § 167(f), prior to its repeal by section 11812(a)(1) of the Omnibus Budget Reconciliation Act of 1990, P.L. No. 101-508, 1991-2 C.B. 481, 543, permitted a taxpayer to reduce salvage value by up to 10 percent of the basis of the property at the time salvage value is determined, for tangible personal property acquired after October 16, 1962, and having a useful life of three years or more. The 10 percent is subtracted from salvage value in computing the annual depreciation deduction and in setting the limit below which the property may not be depreciated. Treas. Reg. § 1.167(f)-1(a). This 10 percent rule is basically a rule to avoid minimal adjustments.

Treas. Reg. § 1.167(a)-11(d)(1) prescribes the rules for salvage value under the elective ADR system. "Gross salvage value" is the amount which is estimated will be realized upon a sale or other disposition of the property in the vintage account when it is no longer useful in the taxpayer's trade or business (or production of income) and is to be retired from service without any reduction for the cost of retiring the asset. Treas. Reg. § 1.167(a)-11(d)(1)(i). "Salvage value" is the gross salvage value less the amount, if any, by which the gross amount is reduced by application of former section 167(f). However, in applying the method of depreciation adopted by the taxpayer, the annual allowance for depreciation of a vintage account is determined without adjustment for the salvage value of the property in the account except that no account may be depreciated below the reasonable salvage value of the account. Treas. Reg. § 1.167(a)-11(c)(1)(i).

For ADR elections, Treas. Reg. § 1.167(a)-11(d)(1)(v) provides that minimal adjustments of reasonable salvage value will not be made. The regulation further provides that since the determination of salvage value is a matter of estimation, the salvage value established by the taxpayer will be deemed reasonable unless there is sufficient basis on the facts and circumstances existing at the close of the year in which the account is established for a determination of an amount of salvage for the account which exceeds the salvage value established by the taxpayer for the account by an amount greater than 10 percent of the unadjusted basis of the account at the close of the taxable year in which the account is established. If the salvage value established by the taxpayer for the account is not within the 10 percent range, or if the taxpayer follows the practice of understating his estimates of gross salvage value to take advantage of this subdivision, and if there is a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account, an adjustment will be made by increasing the salvage value established by the taxpayer for the account by an amount equal to the difference between the salvage value as determined and the salvage value established by the taxpayer for the account. For purposes of this subdivision, a determination of salvage value includes all determinations at all levels of audit and appellate proceedings, as well as all final determinations within the meaning of section 1313(a)(1).

There is substantial case law that establishes that estimates of an asset's useful life and salvage value are determined with respect to the taxpayer's business and not an asset's innate economic useful life. In Massey Motors, Inc. v. United States, 364 U.S. 92 (1960), the Supreme Court held that the taxpayer was required to compute depreciation of the asset over the period of useful life to the taxpayer in his business, and not over its longer economic useful life. The Court noted that when the assets (i.e., automobiles) were not held for their full economic life, they had substantial salvage, resale, or second-hand value. Similarly, see Hertz Corp. v. United States, 364 U.S. 122 (1960), in which the Supreme Court upheld the validity of the regulations under section 167 which provide that "useful life" means the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business and that an asset shall not be depreciated below a reasonable salvage value.

In Ray Clymer, Jr. and Denison Poultry & Egg Co. v. Commissioner, T.C. Memo. 1984-203, the court disagreed with the taxpayer's argument that an asset's resale value is an inappropriate factor in determining salvage value. Rather, the court found that at the initial estimation of salvage value, it is appropriate to consider projected appreciation. Similarly, see Carland, Inc. v. Commissioner, 909 F.2d 1101 (8th Cir. 1990), in which the court found that the salvage value of an asset is not necessarily its "scrap" value; it is the amount that a taxpayer can reasonably expect to receive for the asset on resale at the end of its useful life.

In Crane and Tractor Parts v. Commissioner, T.C. Memo. 1984-510, the taxpayer estimated a three-year useful life and 15 percent salvage value on heavy equipment. The court agreed with the Service's determination of a 16-month useful life and a 60 percent salvage value. The court found that the Service did not use hindsight in its determinations. Rather, the court found that the Service relied on the actual practice and experience of the company for prior years.

Fribourg Navigation Co. v. Commissioner, 383 U.S. 272 (1966), involved the tax consequences of an unanticipated sale of an asset, prior to the end of its useful life, at a price far exceeding its adjusted basis. In Fribourg, unforeseen circumstances (the Suez crisis) created an acute shortage of cargo ships, and the taxpayer was able to sell his ship at a substantial gain. The Commissioner had disallowed the depreciation deduction for the year of sale on the reasoning that the tremendous appreciation in the value of the ship was inconsistent with any allowance for depreciation. In holding that depreciation was allowable, the Supreme Court noted that depreciation of assets and the gain on the sale of assets are independent concepts, and that an unanticipated increase in value should have no impact on depreciation provided that the original estimation of useful life and salvage value was reasonable.

EXAMPLE:

A acquires a ship for $50,000,000 from the manufacturer on November 1, 1980. The ship is placed in service on December 1, 1980. A elects to depreciate the ship under ADR. Assume A makes the section 167(f) election and $12,500,000 is A’s estimate of the salvage value. Under former I.R.C. § 167(f), A's return shows a salvage value of $7,500,000 ($12,500,000 - $5,000,000). As an ADR elector, A's estimated salvage value of $7,500,000 (with § 167(f) reduction) will not be adjusted unless there is a sufficient basis in facts and circumstances existing at the close of the 1980 taxable year to determine that the salvage value (unadjusted by § 167(f)) is greater than $17,500,000 ((10% x $50,000,000) + $12,500,000). Thus, for example, if the Service concludes that the proper salvage value is $20,000,000, the Service can redetermine the proper salvage value. Treas. Reg. § 1.167(a)-11(d)(1)(v). This value, in turn, will be reduced to $15,000,000 to reflect the adjustment under § 167(f) ($20,000,000 - (10% x $50,000,000)).

Further, if there is not a sufficient basis to determine that the salvage value (unreduced by § 167(f)) exceeds $12,500,000, no adjustment to salvage value could be made unless A claimed a salvage value of less than $2,500,000 [$7,500,000 ($12,500,000 reduced $5,000,000 by 167(f) minus $5,000,000 (§ 1.167(a)-11(d)(1)(v) 10% of unadjusted basis limitation on adjustment)].

Conclusion:

The salvage value of ships must be estimated to determine depreciation for ships placed in service before January 1, 1981.